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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1940

No. 627

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

WILLIAM FLACCUS OAK LEATHER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR CERTIORARI FILED DECEMBER 18, 1940
CERTIORARI GRANTED FEBRUARY 10, 1941

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1 Before United States Board of Tax Appeals

Docket No. 96187

WILLIAM FLACCUS OAK LEATHER COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket entries

Appearances: For Petitioner: W. T. Royston, C. P. A., John A. McCann, Esq. For Respondent: Orris Bennett, Esq.

1938

Nov. 18—Petition received and filed. Taxpayer notified. (Fee paid.)

Nov. 18—Copy of petition served on General Counsel.

Dec. 3—Answer filed by General Counsel.

Dec. 3—Request for Circuit hearing in Pittsburgh, Pa., filed by General Counsel.

Dec. 17—Notice issued placing proceeding on Pittsburgh, Pa. Calendar. Answer and request served.

1939

Aug. 22—Hearing set Sept. 11, 1939, in Pittsburgh, Pa.

Sept. 11—Hearing had before Mr. Smith on merits. Stipulation of facts filed. Petitioner's brief due 11/1/39—Commissioner's brief due 12/1/39—Petitioner's reply due 12/15/39.

Sept. 22—Transcript of hearing of Sept. 11, 1939, filed.

Oct. 30—Brief filed by taxpayer. 10/30/39 copy served on General Counsel.

Dec. 1—Brief filed by General Counsel.

1940

Jan. 10—Memorandum opinion rendered—Charles P. Smith, Division 5. Decision will be entered for the respondent.

Jan. 10—Decision entered—Charles P. Smith, Division 5.

Apr. 8—Petitioner for review by U. S. Circuit Court of Appeals, Third Circuit, filed by taxpayer.

Apr. 8—Proof of service filed.

Apr. 12—Concise statement of points filed by taxpayer—proof of service thereon.

Apr. 12—Stipulation as to the contents of record filed.

2 Before United States Board of Tax Appeals

[File endorsement omitted]
[Title omitted.]

Petition

Filed Nov. 18, 1938

The above-named petitioner petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:B:7:8–ECE:90D) dated October 1, 1938, and as a basis of its proceeding alleges as follows:

1. The petitioner is a Pennsylvania corporation, with its principal office and place of business at 1228 River Avenue, N. S., Pittsburgh, Pennsylvania.

2. The notice of deficiency (a copy of which is attached hereto and marked "Exhibit A") was mailed to the petitioner on October 1, 1938.

3 3. The taxes in controversy are income and excess-profits taxes for the calendar year 1935, in the respective amounts of $10,055.72 and $3,656.63, respectively. For that year, petitioner filed its income and excess-profits tax return with the Collector of Internal Revenue for the Twenty-third Collection District of Pennsylvania, at Pittsburgh, Pennsylvania.

4. The determination of taxes set forth in said notice of deficiency is based on the following errors:

(a) Respondent erroneously included in income of petitioner for 1935 the sum of, to wit, $73,132.50, received by petitioner during 1935 as insurance compensation for loss sustained by petitioner in 1935 through the destruction, in that year, of business assets of petitioner having a then value of not less than $73,132.50; whereas said sum did not constitute income to petitioner in 1935 through the destruction, in that year, of business Constitution of the United States.

(b) In the alternative to the error set forth in subparagraph 4 (a) hereof, respondent erroneously (inter alia, by error in classification) included said sum of, to wit, $73,132.50 (derived as aforesaid) in ordinary income of petitioner instead of including it in capital gain and offsetting against said capital gain petitioner's 1935 capital losses in the sum of to wit, $73,222.38.

4 (c) In the alternative to the errors set forth in subparagraphs 4 (a) and 4 (b) hereof, respectively, respondent erroneously limited to $2,000 the deduction allowable to peti-

tioner for 1935 on account of losses sustained in 1935 in the sale and/or exchange by petitioner of assets (consisting of various securities issued by other corporations and not part of the inventory of petitioner or held by it as investments and not primarily for sale to its customers); whereas said limitation has no application to petitioner, a corporation.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a-1) On or about September 25, 1935, one of petitioner's plants, commonly known and designated as the Buckhannon Tannery, located at Buckhannon, West Virginia, and machinery, merchandise, and equipment therein were destroyed by fire. Said plant and other assets had a then fair market value, and had cost petitioner the sum of, not less than, $73,132.50. Said plant and other assets had a then sound value of not less than $73,132.50. Petitioner sustained an actual loss of not less
5 than $73,132.50 by reason of said fire (without regard to insurance).

(a-2) Petitioner received, in 1935, a full settlement of insurance carried by it on said assets, and in compensation for said loss, the sum of, to wit, $73,132.50.

(a-3) Said sum of, to wit, $73,132.50, received as aforesaid, did not constitute income to petitioner within the meaning of the Sixteenth Amendment to the Constitution of the United States. Said sum was merely compensatory and in an amount not exceeding petitioner's actual loss sustained in said fire.

(b-1) During and for the year 1935, petitioner had and sustained capital losses, in the sum of not less than $73,222.38.

(b-2) The amount received by petitioner as insurance compensation for said fire loss in said year was, to wit, $73,132.50.

(b-3) Respondent treated the whole of said sum of $73,132.50 (compensation) as ordinary income of petitioner and limited the deduction allowable to petitioner by reason of said capital losses of $73,222.50 to $2,000. Said $73,132.50, if it constituted income
6 at all, was capital gain of petitioner received in 1935 and should have been offset by said capital losses.

(c-1) Respondent limited said capital losses, in the amount of, to wit, $73,222.38 to $2,000, purporting to act within the purview of Section 117 (d) of the Revenue Act of 1936. Said limitation of $2,000 does not apply to petitioner, an ordinary business corporation. Petitioner is not a bank or a trust company.

Wherefore, the petitioner prays:

(1) That this Board may hear the proceeding and find and adjudicate:

(a) Said insurance compensation for fire loss—received by petitioner—did not constitute income to petitioner within the meaning of the Sixteenth Amendment to the Constitution of the United States.

(b) In the alternative, said insurance compensation, if it constituted income, consisted of capital gain, against which should be offset capital losses.

(c) The $2,000 limitation on capital net losses, contained in Section 117 (d) of the Revenue Act of 1934 does not apply to petitioner, which is a corporation but not a bank or trust company.

7 (d) That there is no deficiency in income tax or in excess-profits tax for the calendar year 1935.

(2) That this Board may grant the petitioner such other and further relief as in the premises it may deem proper; and that, in case an overpayment of taxes has been made this Board may so find and determine and may further determine as part of its decision the portion thereof paid within three years before the filing of this petition.

W. T. ROYSTON,
JOHN A. MCCANN,
Counsel for Petitioner.

JOHN A. MCCANN,
535 Union Trust Building,
Pittsburgh, Pennsylvania, and

W. T. ROYSTON,
2020 Farmers Bank Building,
Pittsburgh, Pennsylvania,
Counsel for Petitioner.

8 [*Duly sworn to by Edward H. Flaccus; jurat omitted in printing.*]

9 *Exhibit A to petition*

OFFICE OF COMMISSIONER OF INTERNAL REVENUE

Address Reply to Commissioner of Internal Revenue and Refer to IT:P:7:8-ECE:90D

TREASURY DEPARTMENT, *Washington, Oct. 19, 1938.*

WILLIAM FLACCUS OAK LEATHER COMPANY,
1228 River Avenue, N. S., Pittsburgh, Pennsylvania.

SIRS: You are advised that the determination of your income tax liability for the taxable year(x) ended December 31, 1935,

discloses a deficiency of $10,055.72 and that the determination of your excess-profits tax liability for the year(x) mentioned discloses a deficiency of $3,656.63 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C1:P-7. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner,
By (Signed) JOHN R. KIRK,
Deputy Commissioner.

Enclosures:
Statement.
Form of Waiver.
ECE/ABF.

10 STATEMENT

IT:B:7:8
ECE:90D

William Flaccus Oak Leather Company
1228 River Avenue, N. S., Pittsburgh, Pennsylvania

TAX LIABILITY FOR TAXABLE YEAR ENDED DECEMBER 31, 1935

	Liability	Assessed	Deficiency
Income tax	$21,062.01	$11,006.2[illegible]	$10,055.72
Excess-profits tax	3,714.19	57.56 [illegible]	3,656.63
Total	24,776.20	11,063.85	13,712.35

In making this determination of your income and excess-profits tax liability, careful consideration has been given to the internal revenue agent's report dated March 24, 1937; to your protest dated May 24, 1937; and to the statements made at the conferences held on July 1, 1937, and January 14, 1938, respectively.

Your contention that the proceeds of the fire-insurance policy should be treated as capital gain subject to the provisions of section 117 of the Revenue Act of 1934 is denied. It is held that the loss of the property through the fire and the receipt of the insurance money was not a sale or exchange or capital assets as it would have to be to come within the provisions of section 117.

A copy of this letter and enclosures has been mailed to your representative Mr. W. T. Royston, in accordance with the authority contained in the power of attorney executed by you and on file with the Bureau.

Adjustments to Net Income

Net income as disclosed by return	$80,191.20
(a) Proceeds of fire insurance	73,132.50
Net income adjusted	153,323.70

ECE/ABF-3

11 William Flaccus Oak Leather Company—Statement

Explanation of Changes

(a) Proceeds of fire insurance, $73,132.50.

The amount of $73,132.50 representing the proceeds of an insurance policy received by you for damages resulting from a fire which destroyed certain buildings and machinery has been included in your gross income in its entirety, since the cost of the buildings and machinery was recovered through depreciation allowance prior to the taxable year.

Your contention that the proceeds of the fire-insurance policy should be treated as capital gain subject to the provisions of section 117 of the Revenue Act of 1934 is denied as it is held that the loss of the property through fire and the receipt of the insurance proceeds in compensation thereof was not a sale or exchange of capital assets as it would have to be to come within the provisions of section 117.

COMPUTATION OF TAX

Income Tax

Net income for taxable year	$153,323.70
Income tax at 13¾ percent	21,082.01
Corrected income-tax liability	21,082.01
Income tax assessed: Original, account #401224	11,026.29
Deficiency in income tax	10,055.72

Net income for excess-profits tax computation		153,323.70
Less: 12½ percent of $632,320.00 value of capital stock as declared in your capital-stock tax return for year ended June 30, 1935		79,040.00
Amount subject to excess-profits tax		74,283.70
Excess-profits tax 5 percent of $74,283.70		3,714.19
Excess-profits tax assessed: Original, account #401224		57.56
Deficiency in excess-profits tax		3,656.63

ECE/ABF-3

12 Before United States Board of Tax Appeals

[File endorsement omitted.]

[Title omitted.]

Answer

Filed Dec. 3, 1938

Comes now the respondent, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed herein, admits and denied as follows:

1. Admits the allegations in paragraph 1 of the petition.

2. Admits that a notice of deficiency was mailed to the petitioner but alleges that it was dated and mailed on October 19, 1938.

3. Admits the allegations in paragraph 3 of the petition.

4. Denies that the Commissioner's determination is based upon errors as alleged in subparagraphs (a), (b), and (c) of paragraph 4.

5 (a–1) to (c–1), inclusive. Denies the allegations of fact contained in subparagraphs (a–1) to (c–1), inclusive, of paragraph 5 of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinabove admitted, qualified, or denied.

Wherefore, it is prayed that petitioner's appeal be denied.

(Signed) J. P. WENCHEL,
G. W. K.
J. P. Wenchel,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:
HENRY C. CLARK,
Special Attorney,
Bureau of Internal Revenue.

13 Before United States Board of Tax Appeals.

[Title omitted.]

John A. McCann, Esq., for the petitioner.

Orris Bennett, Esq., for the respondent.

Memorandum opinion

January 10, 1940

SMITH: This proceeding involves a deficiency of $10,055.72 in income tax and $3,656.63 in excess-profits tax for 1935. Petitioner alleges that the respondent erred in including in its taxable income an amount of $73,132.50 received from an insurance company as compensation for loss of its buildings, machinery, and equipment by fire. In the alternative it is alleged that the respondent erred in treating the said amount of $73,132.50 as ordinary income rather than as a capital gain. Also, in the alternative, petitioner alleges that the respondent erred in limiting to $2,000 the deduction to which it was entitled on the sale or exchange of certain securities. The facts were stipulated, and are substantially as follows:

The petitioner is a Pennsylvania corporation with its principal office and place of business in Pittsburgh, Pa. For the year 1935 the petitioner filed its income and excess-profits tax return with the Collector of Internal Revenue at Pittsburgh. Petitioner's net income as disclosed by its return was $80,191.20. The respondent determined additional net income of $73,132.50, making a net adjusted income of $153,323.70.

On or about September 25, 1935, the plant which the petitioner owned and used for productive purposes, located at Buckhannon, W. Va., was destroyed by fire. The buildings, machinery, equipment, and merchandise were all destroyed. During 1935 the petitioner received insurance in compensation for its loss of $174,898, of which $101,765.50 was for the merchandise and inventory, and $73,132.50 was for the buildings, machinery, and equipment. Prior to the taxable year 1935 the buildings, machinery, and equipment referred to above had been completely depreciated on the books and records of the petitioner for income-tax purposes.

At no time during the taxable year 1935, nor at any time thereafter, did the petitioner set up a replacement fund or expend any of the insurance proceeds referred to above in the acquisition of other property similar or related in services or use to the property destroyed or in the acquisition of control of a corporation owning such other property.

In its income and excess-profits tax return for 1935 petitioner returned the insurance proceeds as capital gain, reporting the

$73,132.50 as the amount of the capital gain on the buildings and machinery. Petitioner also reported other capital gain on sales of securities in the amount of $862.50, which transactions are not here in issue. It also reported capital losses in the amount of $76,767.62, the amount of which is not here in issue. Petitioner offset the total capital gain reported in the amount of $73,995 against its total capital loss reported of $76,767.62, thus reflecting on its return a net capital loss of $2,772.62, of which it claimed $2,000 as allowable under section 117 of the Revenue Act of 1934.

14 In his audit of the return the respondent eliminated from capital gain the amount of insurance received, as above stated, and thus found petitioner's capital loss to be $75,967.62 of which only $2,000 was allowed as a deduction under the limitation provided by section 117 (d) of the Revenue Act of 1934. Respondent thus increased the capital loss exclusion from $772.62 to $73,967.62, and increased disallowance of the capital loss in the amount of $73,195. Respondent then added the $73,132.50 of insurance received to petitioner's ordinary income.

The pertinent provisions of the statute are found in the following sections of the Revenue Act of 1934:

"SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

"(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

"(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

"SEC. 112. RECOGNITION OF GAIN OR LOSS.

"(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * *

"(f) *Involuntary Conversions.*—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under

regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

"SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

"(d) *Limitation on Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. * * *"

15 In its brief the petitioner makes no argument in support of its contention that the insurance proceeds received in 1935 on account of the loss of its buildings and machinery and equipment, which had been wholly depreciated for income-tax purposes in prior years, did not constitute taxable income within the meaning of the Sixteenth Amendment to the Constitution of the United States. The contention is without merit. The gain from the receipt of the proceeds of a fire-insurance policy is clearly within the broad definition of gross income contained in section 22 (a) of the Revenue Act of 1934. The petitioner has suggested no reason why the tax upon such gain should be held objectionable on constitutional grounds and we know of none.

In its brief petitioner directs its argument chiefly to the contention that the gains resulting to it by reason of the receipt of the insurance proceeds were capital gains within the meaning of section 117 of the Revenue Act of 1934 rather than ordinary income as determined by the respondent. This identical question was decided adversely to petitioner's contentions in Estate of George Herder et al., 36 B. T. A. 934; affirmed on this point by the Court of Appeals for the District of Columbia, 106 Fed. (2d) 153. We there held that the taxpayer's loss by fire of a rice mill was not a "sale or exchange" within the meaning of section 117 (a) of the Revenue Act of 1934 and that the gain resulting from the collection of the insurance on the property was taxable as ordinary income. The court in its opinion said:

"Petitioners very strongly urge that the taxable income growing out of the involuntary conversion of the mill, should not be, in any event, treated as ordinary income, but should be treated as a capital gain and subjected to taxation under sec. 117. They contend that the definition of 'sale or exchange' of the capital gain and loss section of the statute is widened by sec. 117 (f), * * *

"It is obvious that the proceeds of the fire-insurance policy did not result from either a sale or exchange of property. * * *" Jackson v. McIntosh, 12 F. (2d) 676, cert. den., 273 U. S. 697; Iowa v. McFarland, 110 U. S. 471; Butler v. Thompson, 92 U. S. 412; Commissioner v. Freihofer, 3 Cir., 102 F. (2d) 787; Hale v. Helvering, 66 App. D. C. 242, 85 F. (2d) 819; Herring Motor Co. v. Aetna Trust & Sav. Co., 154 N. E. 29; Hartwig v. Rushing, 183 P. 177, 93 Cr. 6; Grace v. McDowell, 120 P. 413, 60 Or. 577.

The petitioner here does not rely upon subdivision (f) of section 117, which obviously has no application to the facts in the instant case, but it calls attention to the above quoted provisions of sections 111 (c) and 112 (a) and (f) of the 1934 Act and submits that—

"In Section 111 of the 1934 Act, Congress provided that gain on sale or exchange should be 'recognized.' In Section 112, it provided that on a sale or exchange, the entire amount of the gain or loss should be recognized 'except as hereinafter provided in this section.' Then follows, in 'this section' 112, subsection 'b' to 'i,' providing, all under the classification of sales or exchanges, various instances in which the entire amount of capital gain should not be recognized. Subsection 112 (f) covers our case, under the title 'Involuntary Conversions.' * * *

16 "The mere fact that involuntary conversions are treated under Section 112, in the light of the wording of subsection 112 (a), indicates clearly that gain or loss realized in connection with such a transaction is considered by the Congress as arising from a 'sale or exchange' for the purposes of Section 112 and Section 117 of the Act."

Petitioner cites Helvering v. Chester N. Weaver Co., 305 U. S. 293, and White et al., Executors v. United States, 305 U. S. 281, in which case the Supreme Court held that a loss to a stockholder from the liquidation of a corporation is a capital net loss and not an ordinary loss. The court pointed out that in case of liquidation section 115 (c) requires the tax to be computed "upon the same basis as in case of sales of the stock." White et al., Executors v. United States, supra. Section 115 (c) is not involved in the instant case and there is nothing in the applicable sections which requires the gain derived from the payment of a fire insurance policy to be treated as a capital net gain. Section 112 (f), which the petitioner states that it relies upon, applies only where there has been a conversion—a compulsory or involuntary conversion—of the property lost into property of equal or related use. There was no such conversion in the Instant case.

We are of the opinion, as stated in the Herder case, that a loss of property by fire is not from a "sale or exchange" of such

property and that the gain or loss therefrom is not to be treated as a net capital gain or loss.

Again petitioner's brief is silent on the second alternative issue in which it contends that the limitation on capital losses does not apply to corporations. Clearly, the statute can not be so construed. It was not so construed by the Supreme Court in the Weaver case. The general heading of section 117 is "Capital Gains and Losses." Subdivision (a) provides that in the case of a taxpayer "other than a corporation" certain percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income, but subdivision (d), which provides that losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges, does not exclude corporations except certain banks and trust companies. Presumably the petitioner has abandoned this issue, since it is not argued in its brief; but in any event we hold that the respondent did not err in limiting petitioner's deduction on account of its capital net losses on the sale of securities to $2,000.

Decision will be entered for the respondent.

Entered: January 10, 1940.

17 Before United States Board of Tax Appeals, Washington

Docket No. 96187

WILLIAM FLACCUS OAK LEATHER COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Decision

January 10, 1940

Pursuant to the determination of the Board, as set forth in its Memorandum Opinion, entered January 10, 1940, it is

Ordered and decided: That there is a deficiency in income tax of $10,055.72, and in excess-profits tax of $3,656.63 for the year 1935.

Enter:

(Signed) C. P. SMITH,
Member.

Entered Jan. 10, 1940.

18 Before United States Board of Tax Appeals

[File endorsement omitted.]

[Title omitted.]

Petition for review by the United States Circuit Court of Appeals for the Third Circuit

Filed April 8, 1940

To the Honorable, the Judges of the United States Circuit Court of Appeals for the Third Circuit:

I

JURISDICTION

William Flaccus Oak Leather Company, your petitioner, respectfully petitions this Honorable Court to review the decision of the United States Board of Tax Appeals entered on January 10, 1940, and finding a deficiency in income and excess profits taxes due from your petitioner for the calendar year 1935, in the respective amounts of $10,055.72 and $3,656.63.

Your petitioner is a corporation organized under the laws of the State of Pennsylvania, having its principal office and place of business at 1228 River Avenue, Pittsburgh, Pennsylvania.

19 The return of income and excess profits taxes in respect of which the aforementioned tax liability arose was filed by your petitioner with the Collector of Internal Revenue for the Twenty-third Collection District of Pennsylvania, located in the City of Pittsburgh, State of Pennsylvania, which is located within the jurisdiction of the United States Circuit Court of Appeals for the Third Circuit.

Jurisdiction in this Court to review the decision of the United States Board of Tax Appeals aforesaid is founded on Sections 1001–3 of the Revenue Act of 1926 as amended by Sections 603 of the Revenue Act of 1928, 1101 of the Revenue Act of 1932, and 519 of the Revenue Act of 1934 (Internal Revenue Code, Sections 1141 and 1142).

JOHN A. MCCANN,
John A. McCann,
Attorney for Petitioner.

20 Before United States Board of Tax Appeals

[File endorsement omitted.]
[Title omitted.]

Notice of filing petition for review

Filed April 8, 1940

To: J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

You are hereby notified that Wm. Flaccus Oak Leather Company, did, on the 8th day of April 1940, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Third Circuit, of the decision of the Board heretofore rendered in the above entitled case. Copies of the petition for review as filed is hereto attached and served upon you.

Dated this 8th day of April 1940.

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals,

Service of copy of Petition for Review acknowledged this 8th day of April, 1940.

J. P. WENCHEL,
Counsel for Respondent.

21 Before United States Board of Tax Appeals

[File endorsement omitted.]
[Title omitted.]

Stipulation of facts

Filed Sept. 11, 1939

The parties hereto, by their respective counsel, hereby stipulate and agree that the following facts may be taken to be true:

1. Petitioner is a Pennsylvania corporation with its principal office and place of business at 1228 River Avenue, N. S., Pittsburgh, Pennsylvania.

2. The taxes in controversy in this proceeding are income and excess profits taxes of the petitioner for the calendar year 1935, in the respective amounts of $10,055.72, and $3,656.63. For that year, petitioner filed its income and excess profits tax return with the Collector of Internal Revenue, for the Twenty-third Collection District of Pennsylvania, at Pittsburgh Pennsylvania.

22 3. The net income of petitioner, as disclosed by its income and excess profits tax return for 1935, was $80,191.20.

Respondent determined additional net income in the amount of $73,132.50, making the net income, as adjusted by respondent, the amount of $153,323.70. The correctness of this adjustment is at issue.

4. On or about September 25, 1935, the plant, owned by the petitioner and used by it for productive purposes, located at Buckhannon, West Virginia, and known as the Buckhannon Plant, was destroyed by fire. Not only the building, but also machinery, equipment, and merchandise were destroyed. During 1935, petitioner received, as insurance, in compensation for its said loss, the amount of $174,898.00, of which $101,765.50 was for merchandise and inventory destroyed. The fire insurance proceeds received for the buildings, machinery, and equipment were $73,132.50.

5. Prior to the year 1935, the said buildings, machinery, and equipment had been completely depreciated on the books and records of the petitioner for income-tax purposes.

6. At no time during the taxable year 1935, nor at any time thereafter, did the petitioner set up a replacement fund or expend any of the insurance proceeds so received in the acquisition of other property similar or related in services or use to the property so destroyed or in the acquisition of control of a corporation owning such other property.

23 7. In its income and excess-profits tax return for the taxable year 1935, petitioner treated said insurance proceeds as capital gain. Respondent treated said proceeds as ordinary income.

8. Petitioner returned the $73,132.50 received as insurance on the buildings and machinery as a capital gain. Petitioner also reported other capital gain on sales of securities in the amount of $862.50, which are not here in issue. Petitioner also reported other capital losses in the amount of $76,767.62, the amount of which is also not in issue. Taxpayer offset the total capital gain reported in the above amount of $73,995.00, against its total capital loss reported of $76,767.62, and thus reflected on the return a net capital loss of $2,772.62, of which it claimed $2,000.00, as allowable under Section 117 of the Revenue Act of 1934. Respondent eliminated from capital gain the amounts received by way of insurance, as above stated, and thus found the capital loss to be $75,967.62, of which $2,000.00 was allowed by respondent as a deduction under the limitation provided by Section 117 (d) of the Revenue Act of 1934. Respondent thus increased the capital loss exclusion from $772.62 to $73,967.62, or an increased disallowance of capital loss in the amount of

$73,195.00. Respondent then added the $73,132.50 received by way of insurance to ordinary income.

JOHN A. McCANN,
Counsel for Petitioner.
J. P. WENCHEL,
A
Chief Counsel, Bureau of Internal Revenue.

24 Before United States Board of Tax Appeals

[File endorsement omitted.]

[Title omitted.]

Concise Statement of the Points Upon Which the Petitioner Intends to Rely on Petition for Review

Filed April 12, 1940

Pursuant to Rule 19 of the United States Circuit Court of Appeals for the Third Circuit and to Rule 75, of the Rules of Civil Procedure for the District Courts of the United States, made applicable to this proceeding by the above Rule 19, of the United States Circuit Court of Appeals for the Third Circuit, the petitioner states the points upon which it intends to rely on Petition for Review of the final order and determination of the Board of Tax Appeals, made and entered herein on January 10, 1940.

1. The Board erred in holding and deciding that the proceeds of petitioner's insurance claim were income at all, under the Sixteenth Amendment to the Constitution of the United States, instead of a return of capital.

25 2. The Board erred in finding, holding, and deciding that there was to be included in income of the petitioner for 1935, the sum of, to wit, $73,132.50, received by petitioner during 1935 as insurance compensation for loss sustained by petitioner in 1935 through the destruction, in that year, of business assets of petitioner having a then value of not less than $73,132.50; whereas said sum did not constitute income to petitioner within the meaning of the Sixteenth Amendment to the Constitution of the United States.

3. In the alternative to the error set forth in paragraph "2" above, the Board erred in finding, holding, and deciding that there was to be included in ordinary income of the petitioner the sum of, to wit, $73,132.50, derived as insurance proceeds, as aforesaid, instead of holding, finding, and deciding that such

insurance proceeds were to be included in capital gain and that there could be offset against such capital gain, the stipulated capital losses of, to wit, $76,767.62, thus leaving the petitioner with an allowable capital loss of $2,000.

4. The Board erred in failing and refusing to allow the petitioner to offset against its gain, if any—from the destruction of some of its capital assets and the payment to it on that account of compensating insurance—the amount of its capital losses otherwise incurred, and further failing and refusing to allow petitioner a deduction for a net capital loss, thus determined, not to exceed $2,000.

26 5. The Board erred in holding and deciding that there was any deficiency in income tax and/or excess-profits tax for the taxable year 1935.

6. The Board erred in failing to hold and decide that there was no deficiency in income tax or excess-profits tax for the taxable year 1935.

7. The Board erred in that the conclusions upon which its decision is based are without any findings of fact of evidence to support them and are contrary to the evidence in the case.

JOHN A. McCANN,
John A. McCann,
Attorney for Petitioner.

APRIL 12TH, 1940.

Service of a true copy of this Designation of Points to be Relied upon on Petition for Review acknowledged and accepted this 12th day of April A. D. 1940.

J. P. WENCHEL,
J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.

_____,
_____,
Attorneys for Respondent.

27 Before United States Board of Tax Appeals

[File endorsement omitted.]

[Title omitted.]

Stipulation as to Contents of Record on Petition for Review

Filed April 12, 1940

It is hereby stipulated and agreed by and between the parties hereto by their respective counsel that the following shall con-

stitute the record on petition for review to the United States Circuit Court of Appeals for the Third Circuit in this cause:

1. Docket entries of the proceedings before the Board of Tax Appeals;
2. Pleadings before the Board, including Petition (with annexed copy of deficiency letter), and Answer;
3. Memorandum findings of fact and Opinion of the Board entered January 10, 1940;
4. Decision of the Board entered January 10, 1940;
5. Petition for Review;
28 6. Stipulation of Facts filed herein.
7. Statement of Points Intended to be Relied upon.
8. This Stipulation.

JOHN A. McCANN,
John A. McCann,
Attorney for Petitioner.

J. P. WENCHEL,
J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.

_____,
_____,
Attorneys for Respondent.

Dated April 12 A. D. 1940.

29 [Clerk's Certificate to foregoing transcript omitted in printing.]

30 In United States Circuit Court of Appeals for the Third Circuit

No. 7420. October Term, 1940

WILLIAM FLACCUS, OAK LEATHER COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Order Assigning Ganey, J., for Argument—Filed July 12, 1940

Appeal from the U. S. Board of Tax Appeals

And now, to wit; this 12th day of July, A. D. 1940, it is ordered that Hon. J. Cullen Ganey, District Judge for the Eastern District of Pennsylvania, be, and he is hereby assigned to sit in above case in order to make a full court.

JOHN BIGGS, Jr.,
Circuit Judge.

[File endorsement omitted.]

31 In United States Circuit Court of Appeals

[Title omitted.]

Minute Entry of Argument and Submission

And afterwards, to wit, the 12th day of July 1940, come the parties aforesaid by their counsel aforesaid, and this case being called for argument sur pleadings and briefs, before the Honorable Charles Alvin Jones and Honorable Herbert F. Goodrich, Circuit Judges, and Honorable J. Cullen Ganey, District Judge, and the Court not being fully advised in the premises, takes further time for the consideration thereof,

And afterwards, to wit, on the 13th day of September 1940, come the parties aforesaid by their counsel aforesaid, and the Court, now being fully advised in the premises, renders the following decision:

32 In United States Circuit Court of Appeals

[Title omitted.]

On Petition for Review of Decision of the United States Board of Tax Appeals

Opinion

Filed September 13, 1940

Before JONES and GOODRICH, Circuit Judges, and GANEY, District Judge

GOODRICH, Circuit Judge: This case comes before the court on petition to review a decision of the United States Board of Tax Appeals in favor of the respondent, Commissioner of Internal Revenue. It presents the question whether money received as insurance for the loss by fire of capital assets is to be treated as ordinary gain or capital gain to the extent that those funds are not reinvested in property similar to that destroyed.

Upon the destruction in 1935 of its plant by fire petitioner received as insurance for the loss of buildings, machinery,
33 and equipment $73,132.50. The taxpayer did not expend any of this money to replace the destroyed property, and since the latter had been entirely depreciated for income-tax purposes prior to the fire, the total amount was taxable gain to the petitioner. The sole issue is whether the gain is to be treated as ordinary income or as capital gain. The petitioner treated it

as capital gain and set it off, together with other capital gain not here in issue, against capital losses in the year 1935. The Commissioner, determining that the insurance proceeds were ordinary income, disallowed the offset. The Commissioner then added the insurance proceeds to ordinary income, and was sustained by the Board of Tax Appeals.

The Revenue Act of 1934, § 117 (d), provides that "Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges." The point at issue here is whether the gain from the receipt of the insurance money was realized from a sale or exchange.

It is good sense and good law that as a general proposition the term "sale or exchange," like other words in a revenue act, is to be accorded its ordinary meaning and is not to be tortured into strained construction. Thus this court held that the redemption of notes by the obligor did not constitute a sale or exchange of the notes by the holder, and the profit realized was ordinary as distinguished from capital gain, Felin v. Kyle, 102 F. (2d) 349 (1939); and this view was confirmed by the Supreme Court in Fairbanks v. United States, 306 U. S. 436 (1939).[1] In Hale v. Helvering, 85 F. (2d) 819 (Ct. App., D. C. 1936), it was held that the compromise of promissory notes for less than their face value when the maker was able to pay in full was not a sale or exchange of capital assets.[2] In Burnet v. Harmel, 287
34 U. S. 103 (1932) it was held that amounts received by the owner of land from oil and gas leases were not "gain from the sale or exchange of capital assets", notwithstanding the fact that under the applicable state law the leases operated to pass title to the oil and gas immediately upon execution.[3]

The latest pronouncements of this court on the subject are Commissioner of Int. Rev. v. Freihofer, 102 F. (2d) 787 (1939) and Polin v. Commissioner of Int. Rev., decided August 12, 1940. In the Freihofer case it was held that a loss resulting to the owner of land from the foreclosure of a mortgage lien thereon was an ordinary as distinguished from a capital loss. In that case this court took the position that only sales voluntarily made by a taxpayer are included in § 117 of the Act of 1934. The same result was reached by the Sixth Circuit in Commissioner of Int. Rev. v. Hammel, 108 F. (2d) 753 (1940). The Second Circuit reached a contrary conclusion in Commissioner of Int. Rev. v. Electro-Chemical Engraving Co., 110 F. (2d) 614 (1940).[4] In

[1] The Felin case was decided under the Revenue Act of 1932, and the Fairbanks case under the Revenue Acts of 1926 and 1928. The Revenue Act of 1934 specifically provides that amounts received upon the retirement of notes, bonds, etc., shall be treated as having been "received in exchange therefor." § 117 (f).
[2] Under the Revenue Act of 1928.
[3] Under the Revenue Act of 1924.
[4] Cert. grant. June 3, 1940.

the Polin case it was held that the abandonment and surrender without consideration of mortgaged property by the mortgagor was not a sale or exchange.

It is clear that a realization of loss or gain by the receipt of insurance after the destruction of property is not a sale or exchange in the usual sense of those words, and it is equally clear that the usual sense ordinarily governs. But of course the Congress may provide that a particular transaction which ordinarily would fall outside of the scope of the meaning of "sale or exchange," may be treated as though it were a sale or exchange. Thus § 117 (f) of the 1934 Act provides that amounts received upon the retirement of "bonds, debentures, notes, or certificates or other evidences of indebtedness . . . shall be considered as amounts received in exchange therefor." It is argued, and we think soundly, that the Congress has so provided with respect to the transaction here in question.

35 Section 112 of the Act of 1934 provides, inter alia:

"(a) General Rule.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * *

(f) Involuntary Conversions.—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

It will be noted that subsection (f) is an exception to subsection (a) which states the general rule with respect to a sale or exchange. This would seem to indicate that the Congress chose to classify, for tax purposes, the involuntary conversion of property by destruction (and other named involuntary methods) as a sale or exchange of that property. No reason is suggested why the term "sale or exchange" should have any different meaning in § 117 than in § 112. This conclusion is further fortified when it is noted that in § 111 (a) and (b) Congress speaks of the gain from the sale or other disposition of property, whereas

in § 111 (c) in providing that § 112 should govern the
36 recognition of gain or loss, it speaks of a sale or exchange.

We hold, therefore, that the gain realized upon the receipt of insurance for the destruction of capital assets is a capital gain within the meaning of § 117(f).

The conclusion here reached is contrary to that reached in Herder v. Helvering, 106 F. (2d) 153 (Ct. App., D. C. 1939).[5] It does not appear from the opinion that the ground upon which we rest our decision was presented to that court. It seems that it was there argued that the insurance proceeds came within the terms of § 117(f) as amounts received ". . . upon the retirement of bonds, debentures, notes or certificates or other evidences of indebtedness . . ."

The decision of the Board of Tax Appeals is therefore reversed.

37 In United States Circuit Court of Appeals

WILLIAM FLACCUS OAK LEATHER COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Judgment—Filed Sept. 13, 1940

Appeal from the United States Board of Tax Appeals

This cause came on to be heard on the transcript of record from the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged, and decreed by this Court that the decision of the said Board of Tax Appeals in this cause be, and the same is hereby reversed.

Philadelphia, September 13, 1940.

HERBERT F. GOODRICH,
Circuit Judge.

[File endorsement omitted.]

38 [Clerk's Certificate to foregoing transcript omitted in printing.

39 [Stipulation in re record omitted in printing.]

[5] Cert. den. 308 U. S. 617 (1939).

40 Supreme Court of the United States

Order allowing certiorari

Filed February 10, 1941

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

[Endorsement on cover:] File No. 44, 976. U. S. Circuit Court of Appeals, Third Circuit. Term No. 627. Guy T. Helvering, Commissioner of Internal Revenue, petitioner, vs. William Flaccus Oak Leather Company. Petition for a writ of certiorari and exhibit thereto. Filed December 13, 1940. Term No. 627 O. T. 1940.

U. S. GOVERNMENT PRINTING OFFICE: 1941